

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

77-4117

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

DOCKET NO. 77-4117

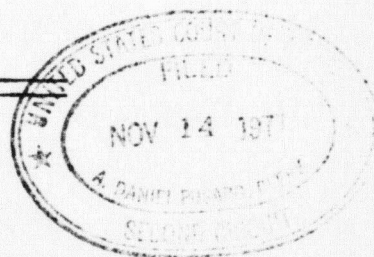
JOSEPH ANASTASIO,
Appellant,

- against -

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

ON APPEAL FROM THE UNITED STATES
TAX COURT

REPLY BRIEF FOR APPELLANT



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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- - - - - X

JOSEPH ANASTASIO, :

Appellant :

v. :

Docket No. 77-4117

COMMISSIONER OF INTERNAL REVENUE, '

Appellee '

- - - - - X

REPLY BRIEF FOR APPELLANT

POINT I

THE GOVERNMENT, LIKE THE TAX COURT, RELIES
UPON THE DOCTRINE OF ECONOMIC BENEFIT
WITHOUT DEFINING IT; AND THUS IMPROPERLY
APPLIES IT

In its brief, the Government is quick to acknowledge the existence of the economic benefit theory for determining whether a cash basis taxpayer realizes income during a taxable year but makes no attempt to define or elaborate upon how it applies to the instant facts--other than by concluding that it does.

The Government attempts to dismiss Appellant-taxpayer's (hereinafter called "Joseph") reliance on

Helvering v. Horst 311 U.S. 112 (1940) - see pp. 23 and 24 of Government's Brief--by suggesting that Horst was merely an assignment of income case dealing only with the person to be taxed and not the proper year of taxation. Since the same Supreme Court which decided Horst, also on the same day decided a companion case, Helvering v. Eubank 311 U.S. 122 (1940) and held in Eubank that the proper year of taxation to an assignor of insurance renewal commissions was the year in which such commissions were paid by the insurance company "For the reasons stated at length in the opinion in the Horst case" 311 U.S., p.125 - the Government's posture as to Horst is clearly contrary to the Supreme Court which had decided it.

However, even more significant than the result reached in Horst, is the fact that it represents the first, and to date, only substantial conceptual exploration by the Supreme Court as to when a cash basis taxpayer realizes income in the absence of its actual or constructive receipt during his taxable year.

Because of the importance of these concepts, they are fully set forth below (311 U.S., pp.115, 116 and 117):

"Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event rather than the acquisition of the right to receive it. And 'realization' is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that

receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him. [Citations omitted]

In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. Cf. Aluminum Castings Co. v. Routzahn, 282 U.S. 92, 98. This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactory actions which are of economic worth. The question here is, whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him, see Old Colony Trust Co. v. Commissioner, *supra*; Bowers v. Kerbaugh-Empire Co., 271 U.S. 170; United States v. Kirby Lumber Co., 284 U.S. 1, or if he sets up a revocable trust with income payable to the objects of his bounty, §§ 166, 167, Revenue Act of 1934, Corliss v. Bowers, *supra*; cf. Dickey v. Burnet, 56 F. 2d 917, 921, he does not escape taxation because he did not actually receive the money. Cf. Douglas v. Willcuts, 296 U.S. 1; Helvering v. Clifford, 309 U.S. 331.

Underlying the reasoning in these cases is the thought that income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. [Citation omitted]"

Some of the conclusions to be drawn from the above are:

1. The taxable event to the cash basis taxpayer occurs in the taxable year when income is "realized", and not necessarily in the year when he acquires the right to receive the income.

2. While realization of income to a cash basis taxpayer may result during a taxable year in which no cash or property is received by him, such realization is deemed to occur only in the year in which the "last step is taken by which he obtains the fruition of the economic gain which has already accrued to him."

3. The cash basis taxpayer realizes income, not actually received, where he has "fully enjoyed the benefit of the economic gain represented by his right to receive income."

4. One who can assign income is taxable because he controls the disposition of that which he could have

received himself during the taxable year and is capable of diverting such income from himself to others as the means of procuring the satisfaction of his wants.

The Government pays no attention to these principles of taxation as applied to a cash basis taxpayer, set forth in Horst. In 1970, Joseph, a cash basis taxpayer, could not obtain the full enjoyment of the lottery award. Such full enjoyment was not available to him until 1971 when he reached age 21. In 1970, Joseph could not freely use or enjoy (by assignment or otherwise) the income represented by the lottery award unless his parents, in their discretion allowed it or a Court, upon review of a petition by Joseph so ordered it - and then only if it met the statutory standards of "support, maintenance, education and benefit" and not for "beneficial extraneous purposes." See Application of Muller 235 N.Y.S. 2d 125 (1962).

Yes, Joseph had won a lottery award in 1970, but his right to receive such award did not ripen into the "fruition of the economic gain which has already accrued to him" in that year; nor did it in 1970 permit his full enjoyment of such economic gain or allow for his "diverting such gain to others as the means of procuring the satisfaction of his wants."

The Government wants to place Joseph on the accrual method for computing income--see Code section 446(c)(2)

and Inc. Tax Regs. sec. 1.446 (c)(ii)--while stipulating that he was a cash basis taxpayer in 1970 (Stip. 6), an allowable method for computing income under Code section 446 (c)(1). If the Government had paid more than lip service to employing the economic benefit doctrine herein, an analysis thereof under Horst would demonstrate clearly that gain (or the right thereto) during a taxable year, is not in and of itself taxable to a cash basis taxpayer, and that realization must be measured by realities, not labels. It is respectfully submitted that Joseph's reality in 1970--i.e., the winning of a lottery award--did not measure up to a cash equivalent under the doctrine of economic benefit for all the reasons explained in Horst.

POINT II

THE GOVERNMENT'S POSITION THAT REALIZATION OF INCOME DEPENDS ON BARE LEGAL TITLE IS CONTRARY TO ITS OWN RULINGS AND THE DECISIONS OF THE SUPREME COURT

It is incredulous that the Government, in spite of all its extended research, did not bother to cite, distinguish or absolve itself from its own position reached in Rev. Rul. 59-154, 1959-1 CB 160 - see also S.M. 4945, V-1C.B. 68 (1926); particularly, in view of Joseph's reference to Rev. Rul. 59-154 in his Opening Brief (pp. 22, 23 and 24) and the fact that Argument I of Joseph's Reply Brief in the Tax Court proceeding reviewing and analyzing the point in issue was

incorporated herein by reference (Joseph's Opening Brief herein, page 23).

Instead, the Government ignores Rev. Rul. 59-154 and argues that Poe v. Seaborn 282 U.S. 101 (1930) stands for the proposition that taxation of income depends on legal title and therefore since Joseph had legal title to the award in 1970 (clearly admitted) he should be taxed on it in 1970. However, this is the same Supreme Court which held in Griffiths v. Helvering 308 U.S. 30 (1939) and Corliss v. Bowers 281 U.S. 376 (1930) that taxation does not rely upon "refinements of title" but rather on "actual command over the property taxed--the actual benefit for which the tax is paid." Both the Tax Court and the Government would tax Joseph \$60,000 in 1970 on a \$100,000 lottery award over which he had no command in that year. These Supreme Court decisions are not in conflict with each other; rather they tell us that the taxation of income depends on reality; and legal title, in and of itself, does not justify taxation. Cf. Higgins v. Smith 308 U.S. 473 (1940); Gregory v. Helvering 293 U.S. 465 (1935); Moline Properties, Inc. v. Comm. 319 U.S. 436 (1943). In Poe v. Seaborn, the Supreme Court found that the wife in a community property state could borrow for and bind the community; that she could enjoin collection of her husband's separate debt out of community property; that she could prevent gifts out of community property by withholding consent; and that the community

property could not be tainted by the husband's torts unrelated to community business. Thus, the wife had substantially more than bare legal title and possessed legal rights by which she could assert her command over the property of the community.

In Rev. Rul. 59-154, the Internal Revenue Service found that:

"The minor children in the instant case, although they hold legal title to the property from which the income is derived, have no control over the property held under the power in trust or the income derived therefrom until they attain their majority, except to the extent that the income is actually applied, in the discretion of the trustees, to their maintenance and support."

Joseph stands in virtually the same position in 1970 as the heirs described in S.M. 4945 or the minor children subject to the power in trust in Rev. Rul. 59-154. Moreover, in the context of Poe v. Seaborn, Corliss v. Bowers and Griffiths v. Helvering, Joseph had no command over the lottery award nor attributes of real ownership which allowed for his full enjoyment of the property in 1970.

It is respectfully submitted that our Internal Revenue Code was never intended to penalize a taxpayer who did not have the right or power to enjoy income during a taxable year. The effect of the Government's position,

if upheld, would be to penalize Joseph \$60,000 in 1970, leaving him with an award of \$40,000 to which he would be, in reality, fully entitled in 1971; thus never fully enjoying \$100,000 in 1970. Even under the Government's position in Rev. Rul. 62-74, 1962-1 C.B. 68, this should not follow. There, the Government ruled that the amount includible from a prize is the present value of the right to the income as determined when the right comes into existence and this present value is the sum of the amount actually received in the first payment (none in this case) plus the present value of the right to receive a future payment as determined by Treasury Department valuation tables under Regulations sec. 20.2031-10. This present value presumably would be reduced by the amount of income taxes attributable to future payments. The inconsistency of treatment displayed by the Government in this case deviating from its stated public position in Rev. Rul. 62-74, is another example of the Government, in reality, imposing a penalty herein in 1970 rather than collecting a tax for the real and full enjoyment of income in 1971.

POINT III

THE GOVERNMENT, BY RELYING ON COMPENSATION CASES, ERRONEOUSLY APPLIES THE ECONOMIC BENEFIT DOCTRINE TO THE FACTS HEREIN

The Government looks to compensation cases to control the disposition of this case. However, the decisions cited by the Government (and the Tax Court below) stem from a specific edict in the Internal Revenue Code (Section 61 of the 1954 Code; section 22(a) of the 1939 Code) which "sweeps into gross income 'compensation for personal service, of whatever kind and in whatever form paid, and income derived from any source whatever'." See United States v. Drescher 179 F.2d 863 (2d Cir. 1950). This statutory edict was reinforced by the Supreme Court in Commissioner v. Smith 324 U.S. 177 (1945) holding that "taxable income includes any economic or financial benefit conferred on an employee as compensation whatever the form or mode by which it is effected."

In Richard T. Armantrout 67 T.C. No. 82 (1977), an arrangement by an employer to fund a trust for children of key employees was deemed compensatory in nature and payments thereunder became taxable to the key employee whose children received benefits therefrom. The employee-taxpayers relied upon Commissioner v. First Security Bank of Utah 405 U.S. 394 (1972) and Paul A. Teschner 38 T.C. 1003 (1962)--see Point II of Joseph's Opening Brief at pages 12,

13 and 14. However, the Tax Court distinguished those decisions since they were not compensation cases. The rationale the Tax Court utilized in Armantrout to emphasize the uniqueness of compensatory arrangements is equally compelling here:

"Hamlin [the employer] and petitioners [the employees] were acting at arm's-length in an employment situation. By accepting employment or continuing to be employed by Hamlin, cognizant of the trust payments, petitioners, in effect, consented to having a portion of their earnings paid to third parties. There is no evidence to indicate that petitioners were unable to bargain with Hamlin about the terms of their employment and the available avenues of compensation. Hamlin could have made available a direct salary benefit to those employees who so desired, and by supplemental enrollment schedule continued to make available the Educo plan to others. We also think significant petitioners' power, whether exercised or not, to designate which of their children would be enrolled in the Educo plan. Under the facts of this case, such power lends substantial compensatory flavor to the Educo arrangement. Petitioners were in a position to influence the manner in which their compensation would be paid, choosing to acquiesce in the payments to the Educo plan was in our view tantamount to an "anticipatory arrangement" prohibited by Lucas v. Earl, supra. By contrast, in neither First Security Bank of Utah, supra, nor in Teschner, supra, did such a potential for "arm's-length" negotiation exist. Moreover, the prohibition on petitioner's receipt of the payments in this case was not imposed by a rule of law as in First Security Bank of Utah, or as the result of a rule imposed by an independent third party as in Teschner. Petitioners herein were not prohibited from receiving income within the meaning of First Security Bank of Utah or Teschner. [See Joseph Opening Brief, pp. 12, 13, 14]

The Government also attempts to take from the specific and apply to the general. It argues (at page 22 of its brief, footnote 21) that "the present physical possession of income is not a prerequisite to its taxation, even to a cash basis taxpayer." Joseph of course, has never made an argument otherwise, nor could he under the principle of Horst. The Government then looks to Code sections 73, 83 and 402(b) for comfort. What the Government overlooks is that section 61 is the general overall provision which requires the taxation of all income. Sections 73 and 83 are specific areas of includibility of income (see section 71 et. seq.) and section 101 et. seq. covers specific areas of excludibility of income. See Code section 61(b). Section 402(b) is included in Subpart D of the Code which deals only with deferred and related problems of compensation. The issue in this case is governed by Code section 61 and the determination of whether income exists thereunder by the application of the economic benefit doctrine. Special areas of includibility which are separated from Code section 61 only because Congressional policy intends to emphasize their specificity are not appropriate to an analysis of the issue herein.

The Government also looks to United States v. Drescher 179 F.2d 863 (2d Cir. 1950) for additional support. However, aside from that decision involving a compensation issue, there were other factors involved therein which

are not present herein. In Drescher, the employee's beneficiaries had an immediate death benefit available - Cf. Stevens v. Comm. 439 F.2d 69 (2d Cir. 1971) and Treasury Regs. sec. 1.72-16(b)--and the employee was free to assign his interest in the policy. 179 F.2d., p. 866.

The Drescher case actually involved an issue of burden of proof and since the taxpayer therein had failed to carry his burden as to proving the value of the annuity contract to him, he was taxed on the full premium paid by his employer. Cf. Rev. Rul. 62-74, where even objective criteria (valuation tables) established by the Government would value Joseph's interest in the lottery award at substantially less than \$100,000. Here, it is Joseph's position that, as a cash basis taxpayer, he was legally disabled (because of minority) from realizing any cash equivalent (either through assignment or otherwise) in 1970. The Government's position is to punish Joseph for winning a lottery in 1970 and not to tax him on receiving the full enjoyment of the economic benefit resulting from the lottery--equivalent to cash--which actually was effected in 1971.

Two final comments. The Government devotes substantial argument to explaining the basis for the enactment of the Uniform Gifts to Minors Act ("UGMA") which was designed only to facilitate gifts to minors. Section 9553(b) of the New York State Lottery for Education Law

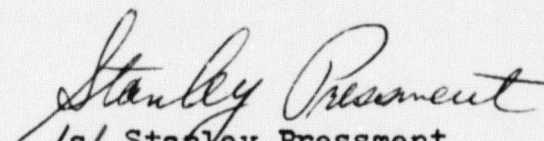
states only that Joseph's parents shall have "the same duties and powers" as a custodian under the New York version of UGMA. It would appear clear that the New York Lottery Law in seeking an appropriate vehicle to select a fiduciary to protect Joseph, as a minor from himself, opted for UGMA. It does not follow, however, that the rationale giving rise for enacting UGMA, i.e., facilitating gifts to minors, should attach to the lottery law which appoints an intervening fiduciary to protect a minor from his winnings. Further, the Government's attribution of awareness to the framers of UGMA and the lottery law as to the income tax rate on trusts being the highest in the Internal Revenue Code (Government's Brief, pp. 17 and 18, footnote 17) is completely without merit. It was not until the Tax Reform Act of 1969 that the trust income tax rate exceeded that of a single individual--New York's version of UGMA was enacted in 1959 and its lottery law was enacted in 1966.

UNITED STATES COURT OF APPEALS
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JOSEPH ANASTASIO, :
Appellant :
-against- :
COMMISSIONER OF INTERNAL REVENUE, : Docket No. 77-4117
Appellee. :
- - - - - X

I, STANLEY PRESSMENT, Attorney for Appellant,
hereby certify that on the 13th day of November 1977,
service of Appellants' Reply Brief was made by mailing
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/s/ Stanley Pressment
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